

Testimony
Of
Mark Papa
On Behalf Of The
Independent Petroleum Association of America
And The
National Stripper Well Association
Before
Committee on Resources
U.S. House of Representatives
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**STATEMENT OF MARK PAPA
FOR THE
INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA
AND THE
NATIONAL STRIPPER WELL ASSOCIATION
AND**

**California Independent Petroleum
Association
Colorado Oil & Gas Association
East Texas Producers & Royalty Owners
Association
Eastern Kansas Oil & Gas Association
Florida Independent Petroleum
Association
Illinois Oil & Gas Association
Independent Oil & Gas Association of
New York
Independent Oil & Gas Association of
Pennsylvania
Independent Oil & Gas Association of
West Virginia
Independent Oil Producers Association
Tri-State
Independent Petroleum Association of
Mountain States
Independent Petroleum Association of
New Mexico
Indiana Oil & Gas Association
Kansas Independent Oil & Gas
Association
Kentucky Oil & Gas Association**

**Louisiana Independent Oil & Gas
Association
Michigan Oil & Gas Association
Mississippi Independent Producers &
Royalty Association
Montana Oil & Gas Association
National Association of Royalty Owners
Nebraska Independent Oil & Gas
Association
New Mexico Oil & Gas Association
New York State Oil Producers
Association
Ohio Oil & Gas Association
Oklahoma Independent Petroleum
Association
Panhandle Producers & Royalty Owners
Association
Pennsylvania Oil & Gas Association
Permian Basin Petroleum Association
Tennessee Oil & Gas Association
Texas Alliance of Energy Producers
Texas Independent Producers and
Royalty Owners
Wyoming Independent Producers
Association**

Mr. Chairman, members of the committee, I am Mark Papa, President of EOG Resources of Houston, Texas. Today, I am testifying on behalf of the Independent Petroleum Association of America (IPAA), the National Stripper Well Association (NSWA), and 32 cooperating state and regional oil and gas associations. These organizations represent the thousands of independent petroleum and natural gas producers that drill 85 percent of the wells drilled in the United States. This is the segment of the industry that is damaged the most by the lack of a domestic energy policy that recognizes the importance of our own national resources. NSWA represents the small business operators in the petroleum and natural gas industry, producers with “stripper” or marginal wells. These producers are the linchpins to continued development of domestic petroleum and natural gas resources.

Today’s hearing addresses the impediments to developing domestic natural gas supply because access to the national resource base is prohibited or constrained. This testimony will focus first on several key factors that influence future energy issues. Second, it will describe issues that are specifically related to natural gas supply issues related to access constraints.

A Nation Dependent on Fossil Fuels

Like it or not, the nation will be dependent on fossil fuels for the foreseeable future. In particular, petroleum and natural gas currently account for approximately 65 percent of the nation’s energy supply – and will continue to be the significant energy source. Natural gas demand, for example, is expected to increase by more than 30 percent over the next decade.

Independent Producers – The Linchpin to Future Domestic Petroleum and Natural Gas

It is important to recognize that the domestic oil and natural gas industry has changed significantly over the last fifteen years. The oil price crisis of the mid-1980’s and policy choices made then triggered an irreversible shift in the nature of the domestic industry. Independent

producers of both oil and natural gas have grown in their importance, and that trend will continue. Independent producers produce 40 percent of the oil – 60 percent in the lower 48 states onshore – and produce 65 percent of the natural gas. They are becoming more active in the offshore, including the deep water areas that have previously been the province of the large integrated companies. At the same time those large companies are now mainly focusing their efforts overseas, in addition to Alaska and the offshore, because they are aiming their investments to seek new and very large fields. Domestic energy policy must recognize this reality.

Recognizing The Role of The Market

Future energy policy should rely on market forces to the greatest degree possible. For natural gas the market is strong and active. Natural gas supply is essentially North American and overwhelmingly from two countries that rely on private ownership and the free market – the United States and Canada. Currently, exploration and development of natural gas in both countries is being aggressively pursued when the opportunities are there, and can be accessed. In the United States drilling rig counts for natural gas are running at rates that are as high as they have ever been since natural gas drilling was distinguished from petroleum. The principal constraints are finding the capital to invest, getting access to the resource base, finding competent personnel, and obtaining rigs. If the market is allowed to work, it will continue to draw effort to produce this critical resource for domestic consumption.

Oil, however, is a different situation. In making decisions regarding developing domestic petroleum resources, the nature of the world petroleum market must be recognized. Although the United States remains the second or third largest producer of petroleum, it is operating from a mature resource base that makes the cost of production higher than in competitor nations. More

importantly, most other significant petroleum producing countries rely on their petroleum sales for their national incomes. For them, petroleum production is not driven by market decisions. Instead, their policies and their production are determined by government decisions. Most are members of OPEC, the Organization of Petroleum Exporting Countries. Several are countries hostile to the United States like Iraq, Libya, and Iran. Even those that are generally supportive of the United States, like Saudi Arabia and Kuwait, are susceptible to unrest from both internal and external forces.

Thus, the market price for petroleum will be largely framed by production decisions driven not by the market, but by the politics of these countries – both by internal issues and global objectives. United States domestic policy decisions must reflect this reality – looking to this factor in taking actions that can affect domestic production and producers. But, more importantly, it must recognize that a healthy domestic oil production industry is also essential for a healthy domestic natural gas industry, because they are inherently intertwined.

For example, the failure of the United States to recognize the need to respond to the low oil prices of 1998-99 resulted in adverse consequences for both oil and natural gas production. The nation has lost about 10 percent of its domestic oil production – most of which has been made up by imports from Iraq. And, in addition, the tight natural gas supplies this year are partially attributable to the drop in natural gas drilling in 1998-99 when oil prices were low and capital budgets for exploration and production of both oil and natural gas were slashed by producers because drilling under those conditions made no economic sense.

The Federal Role

The predominant areas where the federal government plays a major role in promoting or inhibiting domestic oil and natural gas production are: providing access to essential capital and providing access to the natural resource base

I. Providing Access to Essential Capital

Because this hearing is primarily focused on the role of resource base constraints, this testimony will only touch on the capital issue. Because oil and natural gas exploration and production are capital intensive and high-risk operations that must compete for capital against more lucrative investment choices, much of its capital comes from its cash flow. The federal tax code is a key factor in defining how much capital will be retained. The Administration and Congress need to enact provisions designed to (1) encourage new production, (2) maintain existing production, and (3) put a “safety net” under the most vulnerable domestic production – marginal wells. Congress has considered a mix of tax reforms that have widespread support. They include provisions to allow expensing of geological and geophysical costs and of delay rental payments that encourage new production, extending the net operating loss timeframe and revising percentage depletion that assist both new and existing production, and a countercyclical marginal well tax credit when prices fall to low levels. All of these are programs that independent producers need because their revenues are limited to their production

Beyond these immediately needed policy changes, new tax policies must be developed to encourage renewed exploration and production needed to meet future demand, particularly for natural gas. In 1999 the National Petroleum Council released its *Natural Gas* study projecting future demand growth for natural gas and identifying the challenges facing the development of

adequate supply. For example, the study concludes that the wells drilled in the United States must effectively double in the next fifteen years to meet the demand increase. Capital expenditures for domestic exploration and production must increase by approximately \$10 billion/year – roughly a third more than today. Generating this additional capital will be a compelling task for the industry. As the National Petroleum Council study states:

While much of the required capital will come from reinvested cash flow, capital from outside the industry is essential to continued growth. To achieve this level of capital investment, industry must be able to compete with other investment opportunities. This poses a challenge to all sectors of the industry, many of which have historically delivered returns lower than the average reported for Standard and Poors 500 companies.

In fact, as the past year has shown, capital markets have not shifted to supporting the energy sector. For the industry to meet future capital demands – and meet the challenges of supplying the nation's energy – it will need to increase both its reinvestment of cash flow and the use of outside capital. The role of the tax code will be significant in determining whether additional capital will be available to invest in new exploration and production in order to meet the \$10 billion annual target.

IPAA Capital Access Policy Recommendations

Short-Term Tax Reforms

- Allow expensing of geological and geophysical costs and of delay rental payments.
- Allow a 5-year net operating loss carry-back for independent producers.
- Eliminate the net income limitation on percentage depletion for marginal wells and the 65 percent net taxable income limit on percentage depletion.
- Create a counter-cyclical marginal well tax credit.

Other Tax Reforms

- Modify the Alternative Minimum Tax.
- Create a plow back or drilling incentive.
- Expand the Enhanced Oil Recovery tax credit.

II. Providing Access to The Natural Resource Base

National energy policy must also recognize the importance accessing the natural resource base. In 1999 the National Petroleum Council in transmitting its *Natural Gas* study concluded:

The estimated natural gas resource base is adequate to meet this increasing demand for many decades.... However, realizing the full potential for natural gas use in the United States will require focus and action on certain critical factors.

Much of the nation's natural gas underlies government-controlled land both offshore and onshore. Policies in these areas have constrained or prohibited access largely based on fears of environmental harm. But, these resources can be developed in an environmentally sound and sensitive manner. The Department of Energy recently released a comprehensive report, *Environmental Benefits of Advanced Oil and Gas Exploration and Production Technology*, demonstrating that the technology is available. And, it is being employed, when exploration is allowed.

Without policy changes, the nation may not be able to meet its needs. The NPC study projects demand increasing by over 30 percent during the next fifteen years. This will require not only finding and developing resources to meet this higher demand, but also to replace the current depleting resources. While many analysts are focusing on how much more natural gas demand will grow, it is equally important to recognize what is happening to existing supply. All natural gas wells begin to deplete as soon as they start producing. However, as our technology has improved, we now are able to identify probable reservoirs more effectively. This allows us to find and produce smaller fields. At the same time extraction technology has also improved our ability to produce our reservoirs more effectively. As a result we have seen depletion rates in places like the Gulf of Mexico double from historic levels while the reservoir size has decreased.

In simple terms this means that we are challenged to find more reserves more quickly and the reserves underlying federal lands become that much more important.

Currently, over 75 trillion cubic feet (TCF) of natural gas in the offshore is off limits to development because of moratoria that are based on technologies that have been replaced decades ago. The rationale for these moratoria is outdated and inaccurate; there must be a reassessment of these decisions in the context of today's technology and tomorrow's needs.

Moreover, it is essential that those areas of the offshore that are scheduled for leasing remain accessible. Specifically, Lease Sale 181 lying off of the Alabama coast must be undertaken. Unfortunately, after years of negotiation to allow this lease sale within negotiated constraints related to its military use and moratoriums that have been established for the Eastern Gulf of Mexico off of Florida, uncertainty remains that some political efforts will be made to halt the sale. Lease Sale 181 is projected to be a significant natural gas area with estimated of about 7.8 TCF – enough natural gas to fuel Florida's 5.9 million households for 16 years. Estimates of potential oil reserves are on the order of 1.9 billion barrels. To prevent this sale in view of the extraordinary environmental safety record of Gulf of Mexico operations when natural gas demand is accelerating would be tragic energy policy decision.

Even in those offshore areas of the Gulf of Mexico that are open for development, the federal policies that determine royalties will also significantly define the extent to which development will occur. For example, over the past half-decade, Gulf of Mexico development has soared, partly because of the Deep Water Royalty Relief Act that specified how royalties would be determined for a set time period. This allowed producers to plan their investments better. However, large integrated companies principally used the 1995 Deep Water Royalty Relief Act and its specific provisions expired in 2000. Now, as independent producers are also

seeking deep water opportunities, the planning window is narrow and the policies are less certain. On the Outer Continental Shelf, marginal properties remain that could be developed if the royalty policies were right. All of these issues need to be addressed with the full understanding that independent producers will be increasingly willing to develop these areas as large integrated companies look toward the Ultra-deep Water and overseas for the large fields that they need to find.

Even as these identified constraints are being addressed, new threats are developing. For example, the Coastal Zone Management Act (CZMA) may become a significant limitation on offshore energy development. This Act was originally developed to allow for better coordination between states and the federal government with regard to the use of the coastal areas of the country. It encouraged states to consider the various uses of its coastal areas and plan more effectively to accommodate those uses. New regulations under the law can give states the authority under certain conditions to prohibit federal activities that violate the state's Coastal Zone Management Plan. It thus becomes a mechanism for activists opposing any offshore energy development to assert authority well beyond the state's sovereign border and limit federal leasing and mineral management actions.

Onshore, the NPC *Natural Gas* study estimates that development of over 137 TCF of natural gas under government-controlled land in the Rocky Mountains is restricted or prohibited. A recent study by the Energy Information Administration concludes that about 108 TCF are under restriction. Regardless, the amount is significant. An inventory of these resources is underway. It is an important first step. But, it is equally important to understand that access to these resources is limited by more than just moratoria. The constraints differ. Monument and wilderness designations clearly prohibit access to some areas. Regulations like the Forest

Service “roadless” policy and prohibitions in the Lewis and Clark National Forest are equally absolute.

At the same time the permitting process to explore and develop resources often works to effectively prohibit access. These constraints range from federal agencies delaying permits while revising environmental impact statements to habitat management plans overlaying one another thereby prohibiting activity to unreasonable permit requirements that prevent production. There is no single solution to these constraints. What is required is a commitment to assure that government actions are developed with a full recognition of the consequences to natural gas and other energy supplies. IPAA believes that all federal decisions – new regulations, regulatory guidance, Environmental Impact Statements, federal land management plans – should identify, at the outset, the implications of the action on energy supply and these implications should be clear to the decision maker. Such an approach does not alter the mandates of the underlying law that is compelling the federal action, but it would likely result in developing options that would minimize the adverse energy consequences.

IPAA Access Recommendations

Overall

- Provide mechanisms to assure that the energy supply consequences of federal decisions be identified early in the decision process and made clear to the decision makers.

Offshore

- IPAA believes it is critical to continue to provide a royalty structure that encourages offshore development. IPAA and others involved in the offshore are working together with MMS and DOE to create a royalty structure that will enhance domestic production.
- Offshore moratoria policies need to be revisited and revised.

Onshore

- Access in the Rockies won't be resolved by a single act. Many areas are limited during certain times of the year by management plans designed to protect various species. While each plan individually provides opportunities for resource development, collectively, they interact to effectively prohibit natural gas and petroleum extraction. The industry must deal with a mosaic of limitations. Some involve land that is completely excluded from natural gas and petroleum exploration and production. Regulatory actions need to be undertaken to consider the energy implications of decisions – both individually and collectively.

There's No Short Term Fix – Recovery Will Take Time

Any realistic future energy policy will take time. There is no simple solution. The popular call for OPEC to “open the spigots” failed to recognize that the low oil prices of 1998-99 reduced capital investment from the upstream industry all over the world. Only Saudi Arabia had any significant excess production capacity and no one knew just how much or whether the oil was of a quality that it could be refined in most refineries. The collateral damage of low oil prices on the natural gas industry is affecting gas supply today and will until the industry recovers. The producing industry lost 65,000 jobs in 1998-99. While about 40 percent of those losses have been recovered, they are not the same skilled workers. If measured by experience level, the employment recovery is far below the numbers. Less obvious, but equally significant, during the low price crisis equipment was cannibalized to keep operating and support industries were decimated. It will take time to develop the infrastructure again to build new drilling rigs and provide the skilled services that are necessary to rejuvenate the industry.

Additional IPAA Policy Recommendations

- Continue Dept. of Energy Oil Data Transparency initiative to develop more accurate information on worldwide supply and demand.
- Create initiatives to train oil and natural gas production workforce through existing and new education programs
- Consider federal financial instruments like the PADDIE MAC concept that would create a FANNIE MAE-like program to help lower the capital costs to the smaller producers so essential to maintaining the nation's marginal wells.

Conclusion

Overall, attracting capital to fund domestic production under these circumstances will be a continuing challenge. This industry will be competing against other industries offering higher returns for lower risks or even against lower cost foreign energy investment options. The slower the flow of capital, the longer it will take to rebuild and expand the domestic industry.

Providing access to the resource base will be critical and requires making some new policy choices with regard to federal land use.

These two issues are the ones that are particularly dependent on federal actions, and should be the immediate focus of this Congress and the Administration.

It is time for this country to take its energy supply issues seriously and develop a sound future policy. Certainly, there is room in such a policy for sound energy conservation measures and protection of the environment. But, energy production – particularly petroleum and natural gas – is an essential component that must be included and addressed at once. Independent producers will be a key factor, and the industry stands ready to accomplish our goals, if policies reflect that reality.